No. 22,290

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

JOHNS-MANVILLE SALES CORPORATION,
a Delaware corporation,

Appellant,

vs.

ELLSWORTH H. EWALD, aka E. H. EWALD,
dba EWALD CONTRACTING COMPANY, and
RELIANCE INSURANCE COMPANY, a Pennsylvania
corporation, as successor in interest to
Standard Accident Insurance Company,
a Michigan corporation,

Appellees.

OPENING BRIEF OF APPELLANT JOHNS-MANVILLE SALES CORPORATION

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JURISDICTION

This action originated in the Arizona Superior Court, Maricopa County (TR 5-18) and was subsequently removed to the United States District Court for the District of Arizona, pursuant to 28 U.S.C.A. Sections 1441 and 1446. (TR 1-4). No defendants were citizens of Arizona and none of the defendants were citizens of Delaware, the State under whose laws the Appellant was incorporated (TR 1-4). The action was civil and an amount in excess of $10,000.00 was sought. (TR 6-8).

Summary Judgment against the Appellant and in favor of Appellee was entered on July 24, 1967. (TR 104-104A). In this judgment, the Honorable William P. Copple, United States District Judge for the District of Arizona, ordered that Appellant's Motion for Summary Judgment was denied, that Appellee's Motion for Summary Judgment was granted, that Appellant take nothing by its complaint as against Appellee and that Appellee recover its costs. (TR 104-104A).

Appellant then moved the Court for an order vacating its judgment and granting Appellant's Motion for Summary Judgment, or, alternatively, for an order granting a new trial or amending the judgment. (TR 108-13.) After this motion was denied, Appellant filed a notice of appeal on September 12, 1967, (TR 116.) and a Designation of Contents of Record on Appeal on September 28, 1967. (TR 121-22.) This Court has jurisdiction to hear this appeal by virtue of 28 U.S.C.A. § 1291.

STATEMENT OF CASE

Appellant, Johns-Manville Sales Corporation, instituted this action in the Superior Courts of Arizona, Maricopa County, to recover the sum of $15,252.00 from Appellee, Standard Accident Insurance Company, now merged with and known as Reliance Insurance Company. (TR 19.) The facts upon which Appellant's claim for relief was based were as follows:

One of the defendants in this action, Ellsworth H. Ewald, dba Ewald Contracting Company, entered into a contract for the construction of manhole and transit conduit ducts with Mountain States Telephone and Telegraph Company. (TR 13.) The work was to be performed on public property, *i.e.,* under city streets in Phoenix and Tempe, Arizona. (TR 36-46.) The contract was dated November 26, 1963 (TR 9) and provided, in relevant part, that:

Article 2

> The Contractor shall furnish all labor and perform all work, including temporary and permanent work, furnish all the necessary tools, equipment and material required for such work,

except such items of material as are specified in said Exhibit "A" to be furnished by the Telephone Company. The Contractor shall complete all work with promptness and diligence to the complete satisfaction of the Telephone Company. All material furnished by the Contractor shall be of the quality specified by the Telephone Company. (TR 9.)

Article 11

The Telephone Company shall have the right to require the Contractor to furnish, at the Telephone Company's expense, (such expense not to be included in the contract price), a bond covering the full and faithful performance of the contract and the payment of all obligations arising thereunder in such form as the Telephone Company may prescribe and with such surety as it may approve. (TR 11.)

In addition, a document entitled "SPECIFIC JOB CONTRACT", attached to the contract and marked Exhibit "A", provided, in part, that:

This is the Exhibit "A" referred to in the foregoing contract dated the Twenty-sixth day of November, 1963, between THE MOUNTAIN STATES TELEPHONE AND TELEGRAPH COMPANY and Ellsworth H. Ewald, an individual doing business as Ewald's Contracting Company. This Exhibit "A" consists of this sheet and the following described contract documents *which are attached hereto and made a part of the Contract:* Prints #1 through #4 of Job A-4-0602 (Project AS 929) Phoenix (Tempe) Arizona. Addendum to Article 6 of this Contract: Addendum to Article 13 of this Contract: Invitation to Bid Letter: *Award to Bid Letter:* and Contractor's Bid attached. (TR 13.) (Emphasis added.)

The "Award to Bid Letter" referred to above does not appear in the bound Transcript of Record; it is attached to the deposition of Samuel Beard as a portion of Exhibit 1 and was forwarded to the Court of Appeals in a separate volume by the Clerk of the District Court. It is dated November 26, 1963, and, after informing Ewald that his bid of $35,710.00 had been accepted, it provided that "A Performance and Payment Bond *will* be required." (Deposition of Samuel Beard, Page 11 and Exhibit 1 attached to the deposition.)

Pursuant to this contract between Mountain States and Ewald, Standard Accident Insurance Company, Appellee's predecessor, as surety, and E. H. Ewald, as principle, executed a Bond, No. B-205288, guarantying full performance of the contract by Ewald. The bond was also executed on November 26, 1963, (TR 17-18) the same date as the contract. (TR 9.) The obligee of this bond was Mountain States Telephone and Telegraph Company. The bond by reference expressly incorporated the contract between Mountain States and Ewald as though the same were fully set forth therein, and provided:

> WHEREAS, the above bounden Principal has entered into a certain written contract with the above-named Obligee, dated the 26th day of NOVEMBER, 1963 . . . which contract is hereby referred to and made a part hereof as fully and to the same extent as if copied at length herein.
>
> Now, Therefore, the condition of the above obligation is such, That if the above bounded Principal shall well and truly keep, do and perform, each and every, all and singular, the matters and things in said contract set forth and specified to be by the said Principal kept, done and performed at the time and in the manner in said contract specified, and shall pay over, make good and reimburse to the above-named Obligee, all loss and damage which said Obligee may sustain by reason of failure or default on the part of said Principal, then this obligation shall be void; otherwise, to be and remain in full force and effect. (TR 17.)

Appellant sold materials worth $15,252.00 to Ewald for use on the job which Ewald had contracted with Mountain States to perform but was never paid for these materials. (TR 59-60.) After demands for payment from Ewald and Appellee were rejected, Appellant commenced this action against Ewald, dba Ewald Contracting Company, Jane Doe Ewald and the surety on Ewald's bond, the Appellee. The Ewalds were never served with process so the only defendant upon whom Appellant obtained service was the Appellee, Reliance Insurance Company, the corporate successor of Standard Accident Insurance Company. After the issues had been joined, Appellee moved for Judgment on the

Pleadings (TR 25-35) and both parties moved for Summary Judgment (TR 55-65 and 66-76), Appellant so moving twice. (TR 77-79.)

The District Court, the Honorable William P. Copple presiding, entered judgment for Appellee on its Motion for Summary Judgment and against Appellant on its Motion on July 24, 1967. (TR 104-105.) He found that there were no genuine issues of material fact and that the Appellee was entitled to judgment as a matter of law. (TR 104.) It is from this judgment that Appellant brings this appeal.

QUESTIONS PRESENTED FOR REVIEW

1. Do the bond and the contract incorporated therein reveal an intent on the part of the parties thereto to benefit directly third persons such as the contractor's materialmen so that a materialman may sue on the bond as a third party beneficiary thereof?

2. Is the contractor's nonpayment of Appellant, the contractor's materialman, a breach of the contract, performance of which was guaranteed by the bond, so that Appellant may recover the contract price from the surety?

SPECIFICATION OF ERRORS

1. The District Court erred in denying Appellant's Motion for Summary Judgment against the Appellee (TR 104-104A) because the evidence before the Court was sufficient to require it to conclude, as a matter of law, that the bond and contract incorporated therein were intended by the parties thereto to benefit a third party such as Appellant, and Appellant, as a third party beneficiary of the bond, was entitled to judgment against Appellee.

2. The District Court erred in denying Appellant's Motion for Summary Judgment against Appellee (TR 104-104A) because there was sufficient evidence before the Court to require it to conclude, as a matter of law, that the contractor-principal's failure to pay Appellant was a breach of a condition of the bond, thereby rendering the surety (Appellee) liable to Appellant.

3. The District Court erred in granting Appellee's Motion for Summary Judgment against the Appellant (TR 104-104A) for the reasons set forth in Specifications 1 and 2, *supra.*

SUMMARY OF ARGUMENTS

1. The evidence before the Court was sufficient to establish, as a matter of law, that the bond and the contract incorporated therein were intended to benefit a third party, such as Appellant, who furnished supplies to the contractor-principal for use on the bonded job and Appellant was, therefore, entitled to recover on the bond as a third party beneficiary thereof.

2. The evidence before the Court was sufficient to establish, as a matter of law, that the contractor-principal's failure to pay Appellant, one of his suppliers, was a breach of a condition of the bond and Appellant was therefore entitled to recover from Appellee, the surety.

ARGUMENT

The parties are in agreement that if Appellant is entitled to recover on the performance bond on which Appellee is the surety, it must do so as a third party beneficiary of the bond and the contract incorporated therein. (TR 27-37.) The parties also agree that plaintiff's rights as a third party beneficiary of the bond and contract are to be determined by Arizona law, since the contract and bond were executed in Arizona and were to be performed there. (TR 27-37.) Consequently, Arizona law concerning third party beneficiaries and principals and sureties must be examined and, when necessary and appropriate, supplemented with law from other jurisdictions before the record can be critically reviewed.

The concept of a third party beneficiary with enforceable rights in a contract to which he was not a party was first enunciated by the Arizona Supreme Court in *Steward v. Sirrine,* 34 Ariz. 49, 267 Pac. 598 (1928). The Court stated there that:

> We think it is the well-settled rule of law that where a person agrees with another, on a sufficient consideration, to do a thing for the benefit of a third person, the third person may

> enforce the agreement, and it is not necessary that any consideration move from the latter. It is enough if there is a sufficient consideration between the parties who make the agreement. *Steward v. Sirrine, supra* at 58, 267 Pac. at 601.

The court did not elaborate as to what type of showing the putative third party beneficiary would have to make in order to avail himself of the third party theory. However, in the next case involving third party beneficiaries, *Treadway v. Western Cotton Oil and Ginning Co.,* 40 Ariz. 125, 10 P.2d 371 (1932), the Court held that in order to enforce a contract to which he was not a party, the third person must show that the contract was intended to benefit him directly. "Incidental benefit will not support the action." *Treadway v. Western Cotton Oil and Ginning Co., supra* at 139, 10 P.2d at 376. (Emphasis added.)

Six years after the *Treadway* case was decided, the Arizona Supreme Court handed down its decision in *Webb v. Crane Company,* 52 Ariz. 299, 80 P.2d 698 (1938). This case is similar in many respects to the instant case. It involved a suit by a subcontractor's materialman against the general contractor and his surety to recover on the contractor's performance bond. There, as in the instant case, the construction work was performed on public property. There, too, the materialman was suing to recover the contract price of goods which he had furnished for use on the job. The materialman in *Webb,* however, had furnished supplies to a sub-contractor, rather than the general contractor, as in the instant case.

The general contractor in *Webb* argued that the subcontractor's materialman could not sue on the bond because the bond was intended to benefit only the obligee named therein, the State of Arizona. The bond, he argued, was not intended by any party to it, the state as obligee, the contractor as principal, or the bonding company as surety, to benefit third persons such as the subcontractor's materialman. Consequently, the general contractor contended, third parties had no right to sue on it. He raised two additional arguments in support of his contentions. First there was

a "labor" bond as well as a performance bond given on this job. Therefore, the general argued, the fact that a labor bond had been given was evidence that neither the surety nor the obligee on either bond intended the performance bond to benefit materialmen of a subcontractor. In addition, the contractor argued that the performance bond was executed pursuant to a statutory requirement and that the legislative intent underlying the statute was to give only the state a right to sue on the bond.

The Court acknowledged that neither the construction contract nor the bond gave, "in express terms a direct right of action on the bond to materialmen . . . ." *Webb v. Crane Company, supra* at 304, 80 P.2d at 701. The Court noted, however, that the performance bond imposed a duty on the general to "promptly pay all . . . subcontractors and materialmen and all persons who shall supply such . . . subcontractors, with material, supplies or provisions for carrying on such work . . . ." *Webb v. Crane Company, supra* at 303, 80 P.2d at 701. This was persuasive evidence that the bond was intended to benefit these categories of third persons and neither of the contractor's other arguments to the contrary was nearly as persuasive. With respect to the first argument, the Court noted that the fact that the contractor had executed a labor bond which did not protect the materialman had no bearing on the materialman's right to sue on the performance bond. Insofar as the second argument was concerned, the Court examined the statute pursuant to which the performance bond was executed and concluded that it was impossible, from a reading of the statute, to ascertain any legislative intent with respect to the right of a third person, other than the state, to sue on the bond. Consequently, the Court resolved the issue by an analysis of the public policy considerations involved.

The Court noted that the materials had been furnished for use in the construction of public buildings. Next, the Court discussed the general rule that public buildings used for public purposes are not subject to the mechanic's lien law and could not, in Arizona, be liened by materialmen or contractors. Consequently,

mechanics and materialmen have a need for a remedy in lieu of the lien law. Stating that the following was a correct statement of the law, the Court quoted from an annotation in 77 A.L.R. to the following effect:

> The right of laborers and materialmen to recover on a bond executed in connection with public works or improvements, where the bond contains a condition for their benefit and is intended for their protection, although the public body is the only obligee named therein, and there is no expressed provision that such third parties shall have any rights thereunder, is affirmed by the great weight of authority. *Webb v. Crane Company, supra* at 310, 80 P.2d at 704.

Apparently basing this decision primarily on these policy considerations, the Court concluded that the performance bond was intended to protect "those who labored or furnished material on the addition to Taylor Hall, as well as the obligee mentioned therein, and was, therefore, a third party bond." *Webb v. Crane Company, supra* at 310, 80 P.2d at 704.

The only other Arizona Supreme Court decision involving a surety's liability to a third party materialman on a performance bond is *Porter v. Eyer,* 80 Ariz. 169, 294 P.2d 661 (1956). In this case, as in *Webb,* a subcontractor's materialman filed suit against the general contractor and his surety, seeking to recover as a third party beneficiary of the performance bond executed by the contractor and surety company. The obligee of the bond was, of course, the owner of the premises and neither the materialman nor any other third person was mentioned in the bond as a beneficiary thereof.

The contractor and surety appealed from a trial court judgment for the materialman alleging that he could not recover on the bond because there was no privity of contract between plaintiff and the contractor. The materialman, however, asserted that he could recover under an Arizona statute, no longer in force, which provided that licensed contractors must procure a surety bond conditioned upon full performance and payment of all sub-

contractors and materialmen before they could begin work on a public project.

The Court said that in order to prevail the third person must show that the bond can be construed to give him a beneficial interest in it. However, the Court held that the statute had to be read into the bond, and, once read into it, the legislative intent to benefit subcontractors and materialmen, which gave rise to the statute, became a part of the bond. The bond, with the statute read into it, became conditioned on payment as well as performance, and nonpayment rendered the surety liable. *Porter v. Eyer, supra* at 173, 294 P.2d at 664.

Both the *Webb* and *Porter* cases raised the third party beneficiary question in a principal-surety context. The court also decided two third party cases which arose in situations outside the principal-surety area after *Treadway v. Western Cotton Oil* but before its definitive opinion in *Irwin v. Murphey,* 81 Ariz. 148, 302 P.2d 534 (1956), to be discussed later. The first of these two decisions, *Seargeant v. Commerce Loan and Inv. Co.,* 77 Ariz. 299, 270 P.2d 1086 (1954) was reaffirmed by the Court in *Irwin v. Murphey.* The second case, *McCain v. Stephens,* 80 Ariz. 306, 297 P.2d 352 (1956), was decided five months prior to *Irwin* and held in effect that in determining whether a person is a third party beneficiary of a contract to which he was not a party, parol evidence outside of the language of the contract can be considered. *McCain* was completely ignored by the Court in *Irwin* and in its only other third party case, *Pioneer Plumbing Supply Company v. Southwest Savings and Loan Association,* 102 Ariz. 258, 428 P.2d 115 (1967).

Irwin v. Murphey, 81 Ariz. 148, 302 P.2d 534 (1956), is the most comprehensive statement of the Arizona law relative to third party benefiiciary contracts, at least in nonprincipal-surety cases. This was a mortgage foreclosure action in which the mortgagee under a building loan agreement sought to foreclose the interest of the mortgagor and determine the rights of appellant, a materialman who claimed a mechanic's lien on the mortgaged

property. The building loan agreement was a simple construction loan document that provided that upon certification that certain amounts of work had been completed, the mortgagee would pay certain amounts of money to the mortgagors. The Appellant, a materialman and unsuccessful lien claimant, answered and counterclaimed asserting that he was a third party creditor beneficiary of the building loan agreement.

In addressing itself to the third party creditor beneficiary argument, the Court reviewed the *Restatement of Contracts* position that "one for whose benefit a contract is made, although not a party to the agreement and not furnishing the consideration therefor, may maintain an action thereon against the promissor" even if he is only an incidental beneficiary. *Irwin v. Murphey, supra* at 152, 302 P.2d at 537. The Court, however, rejected the *Restatement* position, stating that in Arizona the rule has always been that in order to prevail as a third party beneficiary of a contract, the contract itself must indicate a direct intent to benefit the alleged third party. Citing its earlier decision in *Treadway,* the Court stated that "the benefit contemplated must be intentional and direct."

> Whether a third-party beneficiary is merely an incidental beneficiary, or one for whose express benefit the contract was entered into and therefore one who can maintain an action on the contract, is always a question of construction. . . . It would not be necessary in such an agreement to identify a beneficiary. It is sufficient if the agreement clearly showed an intent that Murphey was to pay directly any person who may furnish labor or material in the construction of such dwelling. *Irwin v. Murphey, supra* at 153, 302 P.2d at 537.

The Court then reviewed the trial court's findings that, although the mortgagee was obligated under the agreement to hold the total amount provided in the note available for his mortgagor, he did not hold any funds "in escrow or in trust for the benefit of any of the defendants." *Irwin v. Murphey, supra* at 154, 302 P.2d at 538. Since the mortgagee could have paid all the funds directly to the mortgagor and had no contractual duty to pay any-

one other than the mortgagor, the Court held that *Irwin* was not a third party benefiiciary under the construction loan agreement. It then concluded its discussion of the third party issue by stating:

> To find that Appellant Irwin was the direct and intentional beneficiary of this agreement, without supporting facts, would be to alter or add to or change the written contract of the parties. Under the law as laid down by this Court and which we feel is stare decisis, it definitely must appear that the parties intend to recognize the third party as the primary party in interest and, as privy to the promise, in order for the third party to recover. *Irwin v. Murphey, supra* at 154, 302 P.2d at 538.

The Supreme Court of Arizona has recently reaffirmed its holding in *Irwin.* In a decision handed down last year, on facts similar to *Irwin,* the Court cited with approval its language in *Irwin* to the effect that in order to recover as a third party beneficiary of a contract, the would-be third party must show that the contract itself reveals an intent to directly benefit him. *Pioneer Plumbing Supply Company v. Southwest Savings & Loan Association,* 102 Ariz. 258, 261, 428 P.2d 115, 118 (1967).

The Supreme Court did not deal at length with the third party beneficiary issue in *Pioneer Plumbing.* Nor did that case involve a surety bond. However, the Arizona Court of Appeals has recently handed down a decision involving a materialman's right to sue as a third party beneficiary on a contractor's performance bond. This case, *Ed Stearman and Sons, Inc., v. State ex rel. Union Rock and Materials Co.,* 1 Ariz. App. 192, 400 P.2d 863 (1965), like the instant case, was an appeal from a summary judgment. In the *Stearman* case, a materialman had furnished material to a subcontractor for use on a state highway construction project. When the subcontractor did not pay the materialman, the materialman brought his action against the general contractor and the contractor's surety under a performance bond which was required by the state.

The general contractor and his surety appealed from a summary judgment granted in favor of the subcontractor's materialman. They argued that since there was no privity of contract between

the materialman and the contractor or the surety, the materialman could not recover on the bond because he was only an incidental beneficiary thereof. This, they contended, was true because the bond was conditioned only on the contractor fulfilling its obligations to the obligee under the bond, the State of Arizona, and they alleged that the contractor had fulfilled all these obligations by paying his subcontractor. It was the subcontractor who had not paid plaintiff.

The Arizona Court of Appeals, after noting that one of the conditions of the bond was that the contractor-principal would pay all laborers, mechanics, subcontractors and materialmen, cited the earlier case of *Webb v. Crane Company, supra,* as controlling. For, the court noted, the facts in the *Webb* case were quite similar and the relevant wording of the bond in *Webb* was the same as the condition of the bond in *Stearman.* The provisions in the bond that the contractor-principal would promptly pay all subcontractor's materialmen was therefore sufficient to make the materialman a beneficiary entitled to sue on and recover under the bond.

The Arizona Court of Appeals was urged, in *Stearman,* to reverse the trial court's decision because of the decision of the Ninth Circuit Court of Appeals in *American Radiator and Standard Sanitary Corporation v. Forbes,* 259 F.2d 147 (9th Cir. 1958), which the contractor and surety argued was controlling. This case involved a suit by a subcontractor's materialman against the general contractor and his surety on a performance bond given pursuant to a State statute which required surety bonds on public construction projects.

The contract between the contractor and the school board provided that the contractor "shall provide and pay for all materials . . . necessary to complete the work." *American Radiator and Standard Sanitary Corporation v. Forbes, supra* at 148. The contractor had, in fact, paid the subcontractor with whom the materialman had contracted, but the subcontractor had not paid the materialman. Consequently, the materialman argued that the con-

tractor had breached the contractual requirement that he "provide and pay for" all materials. In addition, the materialman contended that the state statute pursuant to which the bond was executed had to be read into the bond and that this statue indicated a legislative intent to benefit the materialmen of subcontractors.

The Circuit Court dismissed both arguments summarily. Insofar as the first argument was concerned, the Court noted that the general contractor had in fact paid the subcontractor with whom the materialman had contracted. This, the Court held, fulfilled the contractor's obligation to pay for all materials used, especially since there was nothing in the contract to indicate that the parties to the contract had intended to benefit subcontractors' materialmen. This conclusion was buttressed by the fact that there was no extrinsic evidence which would prove such an intention. There was, therefore, no breach of the contract between the contractor and the Board of Supervisors.

With respect to the second contention, the Circuit Court of Appeals was unable to find any evidence that the legislature intended the statutory performance bond to benefit subcontractor's materialmen. Consequently, the Court concluded that the subcontractor's materialmen could not rely on the statute to make him a third party benefiiciary of the bond. The Court stated:

> The bond on its face contains two defenses to this action: (1) that the Bonding Company shall indemnify the named obligee (the school district or the Board of Supervisors), and (2) that third parties are expressly denied the right to sue thereon. *American Radiator and Standard Sanitary Corporation v. Forbes, supra* at 150.

Hence, even though "Arizona follows the rule that the provisions of a bond will be construed most strongly against a paid surety," the rule could not aid the materialman before the Court. The language in the bond was too clear to leave room for construction since it expressly stated that third parties could not sue on it. *American Radiator and Standard Sanitary Corporation v. Forbes, supra* at 150.

The Arizona Court of Appeals in the *Stearman* case found the *American Radiator* case to be clearly distinguishable from the case before it because of the fact that the bond in *American Radiator* expressly provided that third parties could not recover on it. *Ed Stearman and Sons, Inc. v. State ex rel. Union Rock and Materials Company, supra* at 195, 400 P.2d at 866. The Arizona court did not, therefore, feel that the *American Radiator* case was in any way controlling.

Both the *American Radiator* and the *Stearman* cases contained statements to the effect that under the Arizona law of principal and surety a contract of surety is to be construed most strongly against the surety. This rule of construction can be traced to the Arizona Supreme Court's decision in *Massachusetts Bonding and Insurance Company v. Lentz,* 40 Ariz. 46, 9 P.2d 408 (1932). There the Court stated that suretyship has become primarily a business, like insurance, and therefore the old common law rule of *strictissimi juris* is no longer applicable to the construction of a suretyship contract if the surety is paid. On the contrary, the Court stated that "the contract will be construed most strongly against the surety and in favor of the indemnitee as are other contracts of insurance." *Massachusetts Bonding and Insurance Company v. Lentz, supra* at 50-51, 9 P.2d at 409.

The foregoing cases adequately summarize the Arizona decisions dealing with third party beneficiaries and with construction of surety contracts. Certain principals set forth in these cases can and must be applied, insofar as relevant, to the facts before the Court presently. Those principals, and the cases from which they are drawn are:

1. A third person can recover on a contract to which he is not a party only if the contract reveals that the parties to the contract intended that the contract would directly benefit the third party or a class of which he is a member. *Pioneer Plumbing Supply Company v. Southwest Savings and Loan Association,* 102 Ariz. 258, 261, 428 P.2d 115, 118 (1967); *Irwin v. Murphey,* 81 Ariz. 148, 153, 302 P.2d 534, 537-38 (1956); *Seargeant v.*

Commerce Loan and Investment Company, 77 Ariz. 299, 303, 270 P.2d 1086, 1089 (1954); *Treadway v. Western Cotton Oil & Ginning Company,* 40 Ariz. 125, 139, 10 P.2d 371, 375-76 (1932).

2. Laborers and materialmen are entitled to recover on performance bonds executed in connection with public works or improvements where the bond contains a condition for their benefit and is intended for their protection even though the public body is the only obligee named in the bond and there is no express provision that such third parties shall have any rights thereunder. *Webb v. Crane Company,* 52 Ariz. 299, 307-10, 80 P.2d 698, 703-04 (1938); *Ed Stearman and Sons, Inc., v. State ex rel. Union Rock and Materials Company,* 1 Ariz. App. 192, 194, 400 P.2d 863, 865 (1965).

3. Surety contracts and bonds will be construed most strongly against a paid surety and in favor of the indemnities thereunder. *American Radiator and Standard Sanitary Corporation v. Forbes,* 259 F.2d 147, 150 (9th Cir. 1958); *Massachusetts Bonding and Insurance Company v. Lentz,* 40 Ariz. 46, 50-51, 9 P.2d 408, 409 (1932); *Ed Stearman and Sons, Inc. v. State ex rel. Union Rock and Materials Company, supra* at 195, 400 P.2d at 866.

Application of these principals to the facts before the Court, plus a further analysis of the particular cases discussed above, reveals that the contract which was incorporated into the bond in the instant case does express a sufficient intent to benefit Appellant directly so that he is entitled to recover on the bond as a third party beneficiary thereof.

The bond provides in part:

> WHEREAS, the above bounden Principal has entered into a certain written contract with the above named Obligee, dated the 26th day of NOVEMBER, 1963 . . . *which contract is hereby referred to and made a part hereof as fully and to the same extent as if copied at length herein.* (TR 17.) (Emphasis added.)

The contract, incorporated by the above reference into the

bond, contains several sections which on their face reveal a specific intent on the part of the bond's obligee, Mountain States, and the principal under the bond, Ewald, to benefit third parties, such as appellant, Ewald's materialman.

Article Eleven of the construction contract states as follows:

> The Telephone Company shall have the right to require the Contractor to furnish, at the Telephone Company's expense . . . a bond covering the full and faithful performance of the contract and the payment of all obligations arising thereunder, in such form as the Telephone Company may prescribe and with such surety as it may approve.

Exhibit "A" of the specific job contract (TR 13) provides:

> This is the Exhibit "A" referred to in the foregoing contract dated the Twenty-sixth day of November, 1963, between THE MOUNTAIN STATES TELEPHONE AND TELEGRAPH COMPANY and Ellsworth H. Ewald, an individual doing business as Ewald Contracting Company.
>
> This Exhibit "A" consists of this sheet and the following described contract documents *which are attached hereto and made a part of the Contract:* . . . Award to Bid Letter: . . . (Emphasis added.)

The "Award to Bid Letter" which was incorporated into the construction contract which, in turn, was incorporated into the bond, was attached as a part of exhibit 1 to the deposition of Samuel Beard. (Deposition pages 8-12.) The first sentence of the last paragraph of this letter states that "A Performance and Payment Bond *will* be required."

Viewed as integrated parts of the contract, Article 11 gave the Telephone Company the right to require Ewald to give a performance and payment bond. The Award to Bid Letter of November 26, 1963, which by virtue of Exhibit "A" to the contract became a part thereof, demonstrates unequivocally that this right was exercised and a performance and payment bond *was* required. These facts, which appear in the contract itself, bring the case within the scope of *Porter v. Eyer,* 80 Ariz. 169, 294 P.2d 661 (1956), and *Irwin v. Murphey,* 81 Ariz. 148, 302 P.2d 534 (1956).

In the *Porter* case, a statute in effect at the time the performance bond sued upon was executed, required that contractors on public projects post performance and payment bonds. This statute, the Court concluded, had to be read into the bond and the bond, although admittedly only a performance bond, because conditioned on both the contractor's performance and his payment of subcontractors and materialmen. The "obvious intent" of the legislature of assuring both completion of the project *and* payment of subcontractors and materialmen also became the intent of the parties to the bond because the bond was admittedly executed pursuant to the statute. *Porter v. Eyer,* 80 Ariz. 169, 173, 294 P.2d 661, 664 (1956). The bond became, as a matter of law, conditioned on the contractor's payment of materialmen who thereby became intended beneficiaries of the bond. Hence, nonpayment of the materialmen was a breach of the bond and the surety became liable to the materialmen for the balance owed them by the contractor. *Porter v. Eyer,* 80 Ariz. 169, 172-74, 294 P.2d 661, 662-64 (1956).

The only difference between *Porter* and the instant case is that the performance and payment bond was required by statute in *Porter* whereas it was required by the contract between Mountain States and Ewald in the case presently before the Court. The contract, however, *must* be read into the present bond just as the statute was read into the bond in *Porter* because it is specifically incorporated into the bond. (TR 17.) In determining the Appellant's right to recover on the bond, all of the provisions of the contract must be construed as a part of the bond and the intent of the parties must be ascertained from reading all of the parts of the contract into the bond. *Westinghouse Electric Corporation v. Mill & Elevator Company,* 254 Iowa 874, 118 N.W.2d 528, 530 (1962); *Gibbs v. Trinity Universal Insurance Company,* 330 P.2d 1035, 1040 (Okla. 1958). Appellee has never disputed this and, in fact, conceded this throughout the proceedings before the trial court. (E.g., TR 27, 34.) With the contract read into the bond, the present bond, like the bond in *Porter*

becomes conditioned on payment as well as performance, even though the bond, read alone, is merely a performance bond. And, the "obvious intent" of the Telephone Company in requiring a payment bond, like the "obvious intent" of the legislature in *Porter,* is to protect the materialmen who furnish supplies to the contractor-principal. It follows here, as it did in *Porter,* that the "persons entitled to payment certainly are third party beneficiaries under the bond." *Porter v. Eyer,* 80 Ariz. 169, 173, 294 P.2d 661, 664 (1956.)

Even without using *Porter,* there are sufficient expressions of an intent to benefit Appellant in the contract to satisfy the *Irwin v. Murphey* requirement discussed earlier.

As mentioned above, article 11 (TR 11) and the Award to Bid Letter (Deposition Exhibit 1) in the contract required the contractor to furnish a performance and payment bond. The performance bond was undoubtedly required to protect Mountain States in the event that Ewald did not complete the construction job. The payment bond, just as clearly, was not intended to protect Mountain States. It needed no protection from Ewald's nonpayment because with respect to the construction project involved here, Mountain States did not contract with any person other than Ewald. Therefore, not having contracted with any of Ewald's materialmen or subcontractors, Mountain States had no need of a payment bond to protect itself from liability to them. They would have no basis for recovering from Mountain States.

By the same token, the payment bond certainly was not required to protect Mountain States from liens which Ewald's subcontractors and materialmen might file against the property upon which the work was performed. The work here was performed upon public property (TR 36, 46) and public property in Arizona is not subject to mechanic's or materialmen's liens. *Webb v. Crane Company,* 52 Ariz. 229, 307-08, 80 P.2d 698, 703 (1938).

Since Mountain States was not contractually liable to the materialmen and subcontractors with whom Ewald might contract, and since the property upon which the work was performed could

not be liened, the requirement in the contract that Ewald furnish a payment bond was clearly not intended for Mountain States' benefit. It could only have been intended to benefit the subcontractors and materialmen with whom Ewald might contract.

There is in the record in this case additional extrinsic evidence that the contractual requirement of a payment bond was actually intended to benefit Appellant. Samuel Beard, a representative of Mountain States Telephone and Telegraph Company, testified during the taking of his deposition, on cross-examination, that "payment bonds were required to protect suppliers in the event of a contractor's nonpayment of bills or labor, and to provide coverage for such persons." (Deposition 19.) This testimony is additional evidence that the contractual requirement that a payment bond be furnished by the contractor was intended to benefit Appellant. It is the type of "extrinsic testimony" which the Ninth Circuit Court of Appeals indicated it would consider when attempting to ascertain if a bond were intended to benefit a third person such as a materialman. *American Radiator and Standard Sanitary Corporation v. Forbes,* 259 F.2d 147, 149 (9th Cir. 1958).

The Arizona Supreme Court, by quoting an annotation with approval in *Webb v. Crane Company,* 52 Ariz. 299, 310, 80 P.2d 698, 704 (1938), held that materialmen have a right

> to recover on a bond executed in connection with public works or improvements, where the bond contains a condition for their benefit and is intended for their protection, although the public body is the only obligee named therein, and there is no express provision that such third parties shall have any rights thereunder . . . .

This conclusion was apparently based on the Court's holding that public property could not be liened in Arizona and that there was, therefore, need for another remedy to protect materialmen who furnished supplies used on public projects. The remedy contemplated by the Courr was obviously a right of action against the surety on the performance bond if "the bond contains a condition for their benefit and is intended for their protection." *Webb*

v. Crane Company, supra. The bond in the instant case, by incorporating the contract which requires the contractor to provide a payment bond, contains "a condition" for the benefit of Appellant, and, as discussed above, was intended to protect him. Thus, since the material furnished here was used on public property, the same policy considerations which prompted the Supreme Court's decision in *Webb* are present here and constitute additional reasons for this court to conclude that Appellant was a third party beneficiary of the bond and contract and entitled to recover on the bond. This is particularly so since, under Arizona law, all ambiguities in the contract and bond are to be construed against the surety. *American Radiator and Standard Sanitary Corporation v. Forbes,* 259 F.2d 147, 150 (9th Cir. 1958); *Massachusetts Bonding and Insurance Company v. Lentz,* 40 Ariz. 46, 50-51, 9 P.2d 408, 409 (1932); *Ed Stearman and Sons, Inc. v. State ex rel. Union Rock and Materials Company,* 1 Ariz. App. 192, 195, 400 P.2d 863, 866 (1965).

There is another persuasive reason why Appellee should be liable to Appellant on the performance bond which was posted.

Under the contract which was incorporated into the bond, the contractor was required to furnish a payment bond (Award to Bid Letter, Deposition Exhibit 1) and to furnish all materials which the contract required of him. (Article 2, TR 9.) Although the bond which he secured in attempted compliance with the contract was only a performance bond, it guaranteed that he would perform *all* of the duties required of him by the contract. (TR 17.) He did not, however, perform two of these contractual obligations. He did not give a payment bond; only a performance bond was given, (TR 17) and he did not pay for the materials which he used (TR 59-60) so he did not "furnish" these materials as required by Article 2 of the contract (TR 9). Therefore, the surety was liable under the performance bond because the principal did not perform all of the obligations, performance of which was guaranteed and which were, as discussed above, intended for the benefit of materialmen.

None of the three Arizona surety decisions discussed above approached the problems concerning the surety's liability in this manner, probably because they were able in each instance to reach the bond without having to use this approach. However, several courts in other states have utilized this theory to allow unpaid materialmen to reach the bond.

The Supreme Court of Kansas, in *Topeka Steamboiler Works, Company v. United States Fidelity and Guaranty Company,* 136 Kan. 317, 15 P.2d 416 (1932), held that a clause in a contract requiring the contractor to "furnish all labor and material" imposed a duty on the contractor to pay for the goods, especially since the contract price which the contractor received was arrived at by making an allowance sufficient to cover their purchase. The court held that:

> When, from the contract as a whole, it is clear that the contractor was to pay for material and labor necessary for the construction of the building, and a bond is given to secure the faithful performance of the contract, materialmen and laborers who have not been paid may sue directly upon the bond. *Topeka Steamboiler Works, Company v. United States Fidelity and Guaranty Company,* 15 P.2d at 419. (Citations omitted.)

The highest tribunal in Missouri recently reached the same conclusion with respect to a contractor's duty to pay for goods which the contract required that he "furnish" in *LaSalle Ironworks, Inc. v. Largen,* 410 S.W.2d 87, 92 (Mo. 1966).

Hollerman Manufacturing Company v. Standard Accident Insurance Company, 61 N.D. 637, 239 N.W. 741 (1931), was a suit by a materialman against the instant Appellee's predecessor on a performance bond identical in all respects to the bond against which this suit was brought. The contract incorporated into the bond in *Hollerman,* like the contract in the principal case, required that the contractor provide a payment and performance bond, conditioned, in addition to faithful performance, on the contractor paying all materialmen who contracted directly with him. The contractor did not, however, furnish a payment

bond. Instead, only a bond identical to the bond involved in the instant case was furnished.

The surety company in *Hollerman* raised the same arguments in defense of the materialmen's suit that the same surety in the instant case raised in its supplemental memorandum of points and authorities in support of its motion for summary judgment. (TR 95-101.) This argument was to the effect that even though the contract which was incorporated into the bond may require a payment bond, if a payment bond was not executed, the contractual requirement must be deemed waived.

The Court, however, rejected this argument. It reasoned that since the contract which required execution of a payment bond was incorporated into the bond, the requirement could not have been waived because it became a part of the bond.

> Under the rules of interpretation, the bond, contract, and specifications must be construed together to give effect to the mutual intention of the parties as it existed at the time of contracting, so far as the same is ascertainable and lawful, and so as to give effect to every part if reasonably practicable, each clause helping to interpret the others, and, when so considered, it is clear that, when the parties united the specifications in the contract into the bond, making the obligation of the contract the obligation of the bond, they intended the bond as security for the payment of labor and material in case the principal made default in payment thereof. *Hollerman Manufacturing Company v. Standard Accident Insurance Company,* 239 N.W. at 744-45.

There are, of course, numerous other decisions in which unpaid materialmen, as third party beneficiaries, were allowed to recover on contractors' performance bonds under facts quite similar to the facts of the instant case. See, *e.g., Royal Indemnity Company v. Alexander Industries, Inc.,* 211 A.2d 919 (Del. 1965); *National Surety Company v. Rochester Bridge Company,* 83 Ind. App. 195, 146 N.E. 415 (1925); *Gibbs v. Trinity Universal Insurance Company,* 330 P.2d 1035 (Okla. 1958); *Engert v. Peerless Insurance Company,* 53 Tenn. App. 310, 382 S.W.2d 541 (1964).

Applying the theory of these cases to the instant case, the contractual provisions requiring Ewald to provide a payment bond and to furnish his materials are sufficient expressions of an intent to benefit third persons to entitle Appellant to sue on the performance bond into which the contract was incorporated as a third party beneficiary thereof. Ewald's failure to provide a payment bond and his failure to furnish materials are breaches of the contract, full performance of which was guaranteed by the performance bond, and Appellant is, therefore, entitled to recover from Appellee on the bond.

CONCLUSION

The rights of the parties to this appeal must be determined in accordance with Arizona law.

The contract which was incorporated into the performance bond was, as a matter of Arizona law, intended to benefit Appellant directly and Appellant was therefore entitled to sue on the bond as a third party beneficiary. As a third party beneficiary of the bond, Appellant was entitled to recover on the bond under either one of two theories.

Under the first theory, when the contract was incorporated into the bond the contractual requirement that the contractor execute a payment bond became a part of the bond and the bond became conditioned on the contractor's payment of Appellant, a materialman. Nonpayment of Appellant was a breach of the payment condition of the bond and Appellant was entitled to recover its unpaid balance from Appellee, the surety on the bond.

Under the second theory, the performance bond guaranteed that the contractor would fully perform the contract. He did not, however, post a payment bond nor did he properly furnish materials as contemplated by the contract. Therefore, he did not fully perform the contract and the surety on the performance bond is liable to Appellant for the contractor's nonperformance, Appellant, being, as a matter of Arizona law, an intended third party beneficiary of the contract.

Under either theory, Appellant was entitled to recover on the bond as a third party beneficiary. This conclusion was required as a matter of law and Appellant respectfully requests that the Court enter an order reversing the district court's judgment of July 24, 1967 and directing the district court to enter judgment for Appellant on its Second Motion for Summary Judgment.

Respectfully submitted,

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I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief complies with those Rules.

____

Earl E. Weeks

Three copies of the foregoing brief were delivered this 16th day of February, 1968, to:

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